**State Board of Equalization**

# OPERATIONS MEMO

For Public Release

No. : 1101
Date: August 20, 2002

**SUBJECT**: **Bad Debts Incurred by Lenders on Purchased Accounts**

## I. PURPOSE

This operations memo provides guidelines and procedures required as a result of the revisions to Revenue and Taxation Code sections 6055 and 6203.5 enacted by Assembly Bill (AB) 599. (Stats. 2000, Ch. 600.) Sales and Use Tax Regulation 1642, *Bad Debts–In General* has been amended to incorporate these statutory changes. The provisions of AB 599 apply to transactions for which taxes were remitted on or after January 1, 2000. Since the taxes for the 4th quarter 1999 were, in most cases, remitted on or after January 1, 2000, with respect to this requirement bad debts incurred in connection with almost all transactions occurring on or after October 1, 1999, are eligible under the provisions of AB 599.

## II. GENERAL BACKGROUND

An account receivable ("account") may be sold with or without recourse. "With recourse" means the retailer must reimburse the purchaser of the account ("lender") for any losses the lender suffers. "Without recourse" means the retailer has no obligation to reimburse the purchaser of the account ("lender") even if the lender cannot recover the full amount of the debt. A lender who purchases an account with recourse may *not* take a bad debt deduction under the Sales and Use Tax Law with respect to any loss it suffers on that account (i.e., uncollectible debt for which it fails to obtain reimbursement from the retailer). However, a retailer who sells an account with recourse may take a bad debt deduction for the amount of uncollectible debt for which the retailer actually reimburses the lender pursuant to their contract, to the extent that such loss represents amounts on which the retailer reported and paid tax. The rules discussed in this paragraph remain the law, and have not been affected by the changes discussed below.

Prior to the adoption of AB 599, a lender who purchased an account was not entitled to claim a sales tax deduction or refund in connection with its losses on the account, whether purchased with or without recourse. In addition, when a retailer sold an account without recourse, the retailer was unable to claim a sales tax deduction or refund for losses suffered by the lender on the account. This meant neither party was eligible to claim a bad debt deduction with respect to losses suffered on accounts sold without recourse. (As discussed below, the Board's memorandum opinion in *WFS Financial, Inc.* (WFS) sets forth an exception allowing lenders, under specified conditions, to take deductions for their losses on accounts which were purchased without recourse and for which tax was paid prior to January 1, 2000.) Under the amendments to sections 6055 and 6203.5 adopted by AB 599, either the retailer or the lender, per their agreement, may now qualify to claim a deduction or refund for losses on an account the lender

purchases without recourse, provided the retailer had remitted tax to the Board on or after January 1, 2000. Although the retailer and lender can agree the retailer is entitled to claim the benefit for any losses, we anticipate this will be a rare occurrence. Therefore, this memorandum focuses on transactions where the lender has the right to claim the bad debt deduction or refund. For this reason, the term "lender" is used throughout this memo with the assumption the lender will be the person claiming the deduction or filing a claim for refund.

For purposes of AB 599, the term "lender" includes any person who purchases an account receivable without recourse directly from the retailer who reported and paid tax. This includes, for example, the purchase of an account where the dealer has financed its own sale of a vehicle. "Lender" also includes a person who holds an account without recourse pursuant to that person's contract directly with a retailer. This means, for example, a private label credit card, which is one issued by a financial institution in the name of a retailer. Such a card usually has the name of the retailer on the front of the card, but since the card is actually issued by a third-party lender, this information is usually on the back of the card. These are not general-purpose credit cards. Rather they can be used to make purchases only from the retailer in whose name they are issued, or in some cases from retailers who are part of the same corporate family.

On or before claiming a bad debt deduction or refund under AB 599, the election agreement between the retailer and the lender specifying which party has the right to claim the bad debt deduction for that account must be filed with the Board. This election agreement may be in any form, but must contain the following elements specified in subdivision (i)(3)(A) of Regulation 1642:

a. The name, address, and seller's permit number of the retailer who reported or will report the tax and the name, address, and seller's permit number, if any, or Certificate of Registration – Lender account number of the lender to whom the account(s) is assigned.

b. An agreement that the retailer relinquishes to the lender all rights to the account.

c. A statement clearly specifying whether the retailer or the lender is entitled to claim any (and all) deductions or refunds as a result of any bad debt losses charged off by the lender for the account(s) covered by the election, the effective date of that election, and a statement that the other party relinquishes all rights to claiming such deductions or refunds.

d. A list of accounts to which the election pertains. If the election is a blanket election for all accounts assigned without recourse by the retailer to the lender or all accounts held by the lender without recourse pursuant to the lender's contract directly with the retailer, the election must so state.

e. The agreement of both the retailer and the lender to furnish any and all documentation requested by the Board to support the deductions or refunds claimed.

f. The acknowledgement by both the retailer and the lender that the Board may disclose relevant confidential information to all parties involved in order to support and confirm any deductions or refunds claimed.

g. If the lender is the person entitled to claim any deduction or refund for bad debts on the account, list the Lender's Certificate of Registration – Lender account number. If the lender does not yet hold such a registration, the agreement of the lender that it will apply for the Certificate of Registration – Lender no later than on the date the lender first claims a deduction or refund for bad debts charged off on the account.

h. A statement that the election may not be amended or revoked unless a new election signed by both the retailer and the lender is filed with the Board.

i. The date of the election and the signatures of the retailer and the lender, or their authorized representatives. If a copy of the signed election is filed with the Board rather than the original, the person with the right under the election to claim the bad debt deduction or refund must retain the election with the original signatures. An election may be signed in counterparts, and its filing would be regarded as perfected as of the filing of the second signed counterpart, provided each counterpart is identical except for the signature and date of the signature. If copies of the signed counterparts are filed with the Board, the person with the right under the election to the bad debt deduction or refund must retain all counterparts with the original signatures.

A retailer with the right to the bad debt deduction pursuant to its election agreement with the lender may, in turn, assign that right to an affiliate pursuant to a separate election agreement between the retailer and its affiliate. A lender with the right to the bad debt deduction pursuant to its election agreement with the retailer may, in turn, assign that right to any other person (whether an affiliate or not) pursuant to a separate election agreement between the lender and its assignee. The right to the bad debt deduction or refund cannot be further assigned other than as described in this paragraph.

If a retailer with the right to the bad debt deduction or refund assigns that right to an affiliate, the election agreement between the retailer and its affiliate must also be filed with the Board (along with the election agreement between the retailer and the lender). The election agreement between a retailer and its affiliate must include all the elements specified in subdivision (h)(3)(A) of Regulation 1642.

While a retailer with the right to a bad debt deduction or refund may assign that right only to an affiliate, a lender with the right to a bad debt deduction or refund may assign that right to an affiliate or *to any other person*. The election agreement between a lender and its assignee must include all the elements specified in subdivision (i)(4)(A) of Regulation 1642.

A lender who has the right to take a bad debt deduction pursuant to an election agreement with a retailer (which includes an assignee of the lender) must register with the Board for a Certificate

of Registration – Lender prior to claiming the deduction or refund. (See Regulation 1642(i)(5)(B).) A person registered as a Lender is required to file a return to report subsequent recoveries, and the return must be filed whether or not the lender makes any recoveries during that reporting period. The lender may claim its bad debt losses on line 10(a)(2) and if that amount exceeds the reported amount of taxable recoveries, the completed return will qualify as a claim for refund. For claims on accounts found worthless and written off prior to January 1, 2002, lenders will need to file separate claims for refund for amounts due them. For accounts found worthless and written off after January 1, 2002, most lenders will use their returns to file their claims for refund.

**WFS Memorandum Opinion**

Prior to the passage of AB 599, the Board considered a claim by a financial institution, WFS, for a refund for bad debts incurred from accounts purchased without recourse, and issued a memorandum decision dated December 14, 2000, setting forth when such transactions can qualify for bad debt deductions. Although the property financed in WFS were automobiles, financing of other types of property, such as vessels and aircraft, may qualify if all requirements of the opinion are satisfied. The Board's decision in WFS provides that a financial institution can claim a bad debt deduction or refund for accounts purchased without recourse if each of the following conditions is met:

a. Claimant's representatives were either present on the dealers' premises or immediately available by telephone, facsimile, or computer connection at the time the vehicles in question were sold.

b. Claimant paid full consideration to the dealers for the receivables in question, i.e., claimant did not purchase the receivables at a discount.

c. The dealers' assignments to claimant of the receivables in question were substantially contemporaneous with the execution of the sales agreements between the dealers and the purchasers."

The Legislature's adoption of AB 599 superseded and replaced the WFS decision. The WFS decision applies through December 31, 1999, but not after the provisions of AB 599 became operative on January 1, 2000. As discussed above, AB 599 generally applies to bad debts incurred in connection with transactions occurring during the 4th quarter 1999 since the taxes on those transactions were generally paid after the January 1, 2000 date specified in AB 599. However, the WFS decision itself applied to a claim for refund that included the 4th quarter 1999. Accordingly, to ensure fair and uniform treatment of all lenders and for administrative ease, a lender may rely on the provisions of either WFS **or** AB 599 for bad debts incurred in connection with transactions that occurred during the 4th quarter 1999. The provisions of WFS and AB 599 are otherwise mutually exclusive.

It is imperative to note that the determination of whether WFS or AB 599 applies is based on the date the taxes were remitted (usually ascertained based on the date at which the sale occurred), not the date the bad debts were incurred. For bad debts incurred in connection with sales of tangible personal property during the 3rd quarter 1999 and earlier, only the provisions of WFS

apply and ***not*** the provisions of AB 599. Generally for bad debts incurred in connection with sales of tangible personal property during the 1st quarter 2000 and later, only the provisions of AB 599 apply and ***not*** the provisions of WFS.[1]

Since the determination of whether WFS or AB 599 applies is based on the date tax was paid but the timing of the bad debt deduction is based on the date the loss is written off, there will be claims submitted which include losses covered by both WFS and AB 599 which were written off in the same reporting period. To illustrate, in the 2nd quarter 2002, a lender writes off two accounts as worthless, one for a sale that occurred in the 1st quarter 1999 and the other for a sale that occurred in the 1st quarter 2000. Tax had been paid for the first transaction prior to January 1, 2000, and the provisions of WFS apply to the loss from that account. Tax had been paid for the second transaction after January 1, 2000, therefore provisions of AB 599 apply to that loss. Since the lender's right to claim the losses from these two accounts was established during the 2nd quarter of 2002, the deduction for both accounts should be taken on the lender's return for that reporting period. This means the statute of limitations for filing the lender's claim related to the losses on both accounts starts to run on July 31, 2002 (the due date of the return for the 2nd quarter 2002).

**Indirect Loans**

If a consumer wishes to make a purchase on credit without using an existing credit account, the consumer may apply for a loan for that particular purchase. This is the method used for most purchases of automobiles, aircraft, and vessels, as well as many other large purchases, such as jewelry. The retailer may coordinate the loan application process, with the consumer signing a credit contract with the retailer who thereafter assigns the account to a lender. This type of loan is commonly called an "indirect loan" because the consumer does not contract directly with the lender who will service the loan, but rather contracts with the retailer. Since the retailer will then assign the account to the lender, bad debts from these accounts may qualify for deduction under AB 599.

**Direct Loans**

Alternately, a consumer may arrange his or her own financing by contracting for a loan directly with a lender. This type of loan is commonly called a "direct loan" because the consumer contracts directly with the lender who will service the loan. In a direct loan situation, the consumer pays for his or her purchase with the proceeds from the loan (plus any down payment or other amounts paid out of the consumer's own funds). Methods of remitting the loan proceeds to the retailer include:

a. a check issued by the lender in the retailer's name, which may be sent directly to the retailer or physically delivered by the consumer;
b. a check issued in the names of both the retailer and the consumer which must be executed by both parties (and which may also be sent directly to the retailer or be physically delivered by the consumer, though the latter is more common because the consumer must also execute the check);
c. and a direct electronic funds transfer from the lender to the account of the retailer.

---

Due to reporting requirements of AB 599, it is *theoretically* possible to have an annual basis retailer sell account receivables to a lender, which would make AB 599 apply to sales made for the entire year of 1999.

The Board held in a separate case that bad debts incurred on certain direct loans are also eligible for deduction under WFS guidelines. In that case, although the purchaser contracted for financing directly with the lender, the lender worked closely with the dealer and remitted payment directly to the dealer. If instead the loan proceeds were to come into the full possession of the consumer (e.g., the consumer deposits the funds into the consumer's own account and then draws from that account to pay the purchase price), the loan would not qualify under WFS. Furthermore, for a direct loan to qualify under WFS, the dealer must receive payment in a manner that is essentially the same as for indirect loans that qualify under WFS. While no specific time frame is required, this usually occurs within ten days of the date of sale. For example, when the loan is for the purchase of a vehicle, a qualifying direct loan would result in the lender's name being placed as lien holder on the ownership certificate as part of the initial registration of the vehicle in the consumer's name. Of course, the other conditions specified in WFS must also be satisfied.

The Board's decision that a lender making a direct loan might qualify for a bad debt deduction under WFS is also applicable to claims for bad debt deductions or refunds under AB 599. However, no deduction or refund is allowable unless and until the lender and the retailer who paid the tax file the election mandated by AB 599, as explained in Regulation 1642. Furthermore, AB 599 applies only when the lender has purchased the account directly from the retailer, or when the lender holds the account pursuant to the lender's contract directly with the retailer. Thus, even if a lender providing a direct loan can convince the retailer to sign an election agreement with the retailer, that does not automatically mean that the losses on the account will qualify for deduction or refund under AB 599. For purposes of the requirements of AB 599 with respect to a direct loan, a lender claiming a bad debt deduction or refund will be regarded as satisfying these conditions if the transaction would have qualified for deduction under WFS (as modified by the Board's ruling on direct loans).

For example, a consumer obtains a line of credit with a lender, perhaps secured by a second deed of trust on the consumer's home. The consumer then uses a check to access the line of credit to purchase a big ticket item. The retailer receiving the check has no contact whatsoever with the lender except to deposit the check and obtain the funds. The lender and retailer thereafter enter into an election agreement. The loss on this account cannot qualify for deduction or refund under AB 599 since the lender cannot be regarded as having purchased the account from the retailer or holding the account pursuant to a contract with the retailer. On the other hand, a consumer applies for a loan from his or her credit union to purchase a vehicle. The consumer then purchases a vehicle under the normal vehicle sales contract giving him or her a stated number of days to pay the purchase price to the dealer. If the consumer does not make payment timely, the sales contract provides for the dealer to carry the loan (which the dealer could promptly assign to a lender, perhaps even the consumer's own credit union). During the completion of the paperwork and during the sale transaction process, the consumer provides information to the dealer regarding the credit union loan. The dealer contacts the credit union directly and after the necessary paperwork is completed, the credit union deposits the funds directly into the dealer's account. This direct loan will be regarded as satisfying the requirements that the lender purchased the account from the dealer, and if the other requirements

of AB 599 are satisfied, the lender is eligible to claim a bad debt deduction or refund under AB 599.

**Refinanced Loans**

When a loan is refinanced with the original lender, there are two situations where a deduction for bad debts incurred on the refinanced loan will be allowed provided all other requirements for a deduction are satisfied. One is when the refinancing is for the purpose of lowering the amount of the payment (through a reduced rate or extension of the term). The other is when the purpose of the refinancing is to obtain additional funds to pay for necessary repairs to the property purchased with the funds from the original loan, but only when the lender makes payment directly to the repair facility. When calculating the amount of the bad debt loss on qualified refinanced loans whose principal amount is increased to pay for repairs, the percentage of taxable loss must be reduced by the nontaxable portion of the repairs (in addition to the other adjustments for the nontaxable portion of the original loan). Losses incurred from refinanced loans through a different lender do not qualify for bad debt deductions, nor do losses from refinanced loans where the borrower withdrew any funds other than amounts paid by the lender directly to a repair facility for necessary repairs to the property originally financed.

**Computing the Amount of the Bad Debt Loss**

A lender must provide a listing of all transactions (electronic or hard copy) for which it claims a bad debt deduction or refund, and must also be able to provide source documents for all such transactions. Transactions should be selected for review based on the auditor's discretion and not that of the lender. The amount of the bad debt for which the claim for deduction or refund is filed frequently includes some nontaxable elements (e.g., tax, license, interest, late fees, etc.). It would thus be highly unusual for a lender to be entitled to a bad debt deduction for the entire amount of its losses on an account. Rather, the lender must adjust the amount of its losses so its claimed deduction includes only the allowable taxable amounts. There are three basic methods of verifying the lender's claim for a bad debt deduction or refund; Actual Basis, Statistical Sampling and Mean Allowable.

Regardless of the method used, prior to beginning verification of the claim, all claimants should be informed that it might later be necessary to expand the size of the sample to ensure a representative sample is taken so the accuracy of the claim is assured. A claimant must be able and willing to provide documentation to support all transactions included in the claim, regardless of accessibility. Transactions for which the claimant is not capable and willing to provide supporting documentation must be disallowed, even in cases where the claimant purports to have documentation but cannot provide copies because it is not readily accessible.

a. Actual Basis

   The lender provides a listing of accounts on an actual basis and computes the amount of the allowable bad debt loss on each account on a transaction-by-transaction basis. The information included in the listing must include the items in Appendix 2 of the regulation. Under this method, the lender computes the claimed bad debt loss for sales and use tax purposes on an actual basis and staff is verifying the accuracy of the lender's listing. Staff should utilize statistical sampling techniques to verify the accuracy of the lender's claimed refund. Staff

must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13.

When statistical sampling is used staff must select a sample size of no fewer than 300 transactions. If the population is less than 300, the transactions should be examined on an actual basis. The auditor may discover no material discrepancies after testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct. If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population. When the sample discloses material discrepancies among the lender's listing, the sample differences must be evaluated before projecting to the population. The Board's Statistical Sampling Evaluation program will be used to evaluate the differences. If the sample evaluates well, a percentage of error should be computed and applied to the population of transactions included on the lender's listing to determine the allowable refund amount. If the sample discloses discrepancies and does not evaluate well, staff should consider expanding the sample.

b. Statistical Sampling

The lender has provided a listing of the bad debt accounts written off per their books but they have not computed the allowable bad debt loss as described in Regulation 1642(d). The amount listed may include non-taxable elements such as tax, license, interest, late fees, repossession fees, etc. Staff must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss. Staff must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13. Staff must select a sample size to examine no fewer than 300 transactions. If the population is less than 300, the transactions should be examined on an actual basis. The lender must provide a listing for the sample that computes the allowable portion of the bad debt on a transaction-by-transaction basis in accordance with Regulation 1642(d). Staff must verify the accuracy of the sample data.

Under this method the lender provided the total write off amount for the population. It includes items not allowable under Regulation 1642. The sample is used to compute an audited allowable amount on a transaction-by-transaction basis. Thus every transaction examined in the sample will show a difference between the audited and claimed bad debt. These differences must be evaluated using the Board's Statistical Sampling Evaluation program. When the sample evaluates well, it will be used to compute an audited allowable bad debt percentage. The allowable bad debt percentage is the audited allowable amount per the sample (computed in accordance with Regulation 1642) divided by the total bad debt claimed in the sample. The allowable bad debt percentage will be applied to the total claimed bad debt to arrive at the total audited allowable bad debt amount. If the sample differences do not evaluate well, staff should consider

expanding the sample. On the other hand, the auditor may discover no material discrepancies after testing a sufficient portion of the sample that the auditor is comfortable in concluding the amount of bad debt loss claimed by the taxpayer is correct. If so, the auditor, in his or her discretion, may terminate the test and accept the amount of bad debt loss claimed by the taxpayer. In reaching this conclusion prior to completing the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population.

c. Mean Allowable

The third method is similar to the second method described above. Under this method a mean allowable bad debt per account is computed in lieu of an allowable percentage. The verification procedures staff must perform are identical to those described in method two above. When the sample evaluates well, it will be used to compute an audited allowable mean bad debt per account.

The mean allowable amount per account is computed by taking the allowable write off amount per the sample (computed in accordance with Regulation 1642) divided by the total number of accounts examined in the sample. The mean allowable amount per account will be applied to the total number of accounts contained in the population to arrive at the total allowable bad debt. If the sample differences do not evaluate well, staff must expand the sample or provide adequate comments to support the application of the results of the sample.

## III. PROCEDURES

### A. General

**Local Tax Verification**

When reviewing a claim for refund under WFS or AB 599, it is imperative the local and district taxes are properly deallocated. For example, when the claimed bad debt loss relates to sales of vehicles, the name and address of the dealer and consumer must be included for each transaction scheduled to properly deallocate the local and district taxes on an actual basis. For loans approved by the lender on a transaction-by-transaction basis, the lender should allocate the local and district taxes on an actual basis. In cases where transaction-by-transaction information is not available and the de-allocation cannot be done on an actual basis, the regulation provides that the lender may allocate local and district taxes on an appropriate basis subject to approval by the Board. When verifying the accuracy of such an alternative method, the audit comments must fully explain the basis for concluding whether or not the alternative method is accurate.

**Required Documentation**

Exhibit 1 “Listing of Documents and Information Needed to Support Bad Debt Deductions in Connection with Repossessed Vehicles” is a comprehensive list of information staff must review when verifying a claimed bad debt deduction or refund incurred in connection with the financing of a vehicle. However, to the extent this

information is not relevant to the actual computation of the allowable bad debt deduction or deallocation of tax, it need not be scheduled. For example, if a statistical sample uses the loan origination number as the basis for selection, this number must be available for all transactions within the population and must be scheduled. If there is a valid reason for not scheduling that information, adequate supporting comments must be included explaining how the information was made available and why it was impractical to include such information in the supporting schedules.

**Disputed Claims for Refund**
In cases where the lender disagrees with staff regarding the qualification of certain types of transactions for a bad debt loss, the Refund Section will process the concurred portion of the claim for refund. The taxpayer will receive the concurred portion of the refund while the disagreed portion of the claim will be forwarded to the Appeals Section, when applicable.

## B. District Responsibilities

**Audit Procedures**
Audit staff will review claims for deduction or refund based on lender bad debts.

District audit staff will:

a. Verify the accuracy of the claim for deduction or refund;
b. Confirm the records provided adequately support the claim for deduction or refund;
c. Ensure the records provided by the claimant are complete, as required by Regulation 1642 (e);
d. Confirm that for claims under AB 599 any claimant who is a lender holds a Seller's Permit or a Certificate of Registration – Lender;
e. Confirm claims under AB 599 have a valid election agreement on file specifying the claimant is the person entitled to claim the deduction or refund for that account; and
f. Verify local and district tax deallocation from the jurisdiction that received the original local or district tax allocation.

For a lender to claim a bad debt deduction or refund, subdivision (i)(2)(B) of Regulation 1642 requires that "the account must have been found worthless and charged off by the lender for income tax purposes." The standard practice of the lending/financial industry requires bad debts to be written off after a prescribed number of days regardless of any collection activity or payment arrangements made with the debtor, and without regard to whether the account is actually worthless. Thus, although accounts may be written off in accordance with industry standard practice, this does not necessarily mean they are worthless. For example, an account may be written off after the prescribed amount of time has passed, but the lender may have a payment plan in effect with a debtor. Although the account may be written off as a bad debt for other purposes, such an account would not generally be considered "worthless" for purposes of Regulation 1642 while the payment plan remains in effect.

Audit staff must include in the general comments section of the audit working papers a comment as to whether the claim for refund qualifies under WFS or AB 599. Both the lender's and retailer's accounts must be cross referenced, indicating the claim for refund, the basis of the claim (WFS or AB 599), and the periods covered for each. The audit must include a review of the election agreement(s) to ensure each agreement is valid under subdivision (h)(3)(A), (i)(3), or (i)(4)(A) of Regulation 1642, as applicable, and pertains to the transactions under audit.

**Registration Procedures**

Only a person registered with the Board as a lender may claim a deduction or refund for bad debt losses on purchased accounts. There is no charge to register nor will any security deposit be required. To register, the lender must submit a completed application for a Certificate of Registration - Lender (BOE-400-MCL) to one of the Board's district offices, and must do so without regard to whether the lender may be registered with the Board for another purpose. For example, a lender who holds a seller's permit must nevertheless register as a lender to claim a deduction for refund as a lender under AB 599. Applications received in headquarters will be forwarded to the appropriate district office for processing.

The district office will process an application for a Certificate of Registration – Lender in accordance with established procedures (CPPM section 225.000) and will issue the Certificate of Registration – Lender (BOE-442-L) to the lender. The district office will assign a TAT of "SL" to a lender who is not currently registered with the Board. A lender who holds a seller's permit will retain its current TAT. To identify the account as a lender the district office will assign an Account Characteristic code of "20." Staff should enter comments in TAR concerning the status of the lender's application and indicate any reason for delay. Once the application is processed the district office will forward the application and supporting documentation (if any) to the Taxpayer Records Unit in headquarters.

Once a person is registered as a lender, it is <u>required</u> to file periodic returns (generally quarterly) even if it will report no tax and claim no deductible losses. Periodic returns, including a *Schedule L,* (BOE-531-L) and *Listing of City and Unincorporated County Codes for BOE-531-F, Schedule F and BOE-531-L, Schedule L* (BOE 531-FL1), will be mailed to the lenders. The lenders will use the Schedule L to make adjustments to the local or district tax associated with the bad debt deduction for the jurisdiction that originally received that tax from the retail sale of the financed property.

## A. Headquarter Responsibilities

**Return Processing Procedures**

**Mail Services Unit, Data Entry Unit, and Verification Unit**

The Mail Services Unit, Data Entry Unit, and Verification Unit will receive and process the sales and use tax returns, along with the Schedule Ls, in accordance with established policy and procedures. Once processed, the returns will be forwarded to the appropriate section based on batch types, IRIS edit messages, or both.

**Cashier Unit**

The Cashier Unit receives the presorted returns from Mail Services Unit. The batch type for SL accounts will be "S." The batch type for sellers who are also lenders will remain the same as the current batch type according to their registered TAT information. During the sort process, those returns with a subsidiary Schedule L attached will be batched into miscellaneous batches. Cashier staff will process the returns in accordance with established policy and procedures. The processed batches will then be forwarded to the Data Entry Unit.

**Return Analysis Section**

The Return Analysis Section (RAS) is responsible for identifying taxpayers who have claimed the lender bad debt deduction on their returns to ensure such persons hold a Certificate of Registration - Lender and have filed the required election agreement as explained in Regulation 1642. When the taxpayer is not registered as a lender but claims a deduction for lender bad debt loss on line 10(a)(2) of its return or files a Schedule L with its return, RAS will contact the taxpayer to advise them the deduction is not allowable since the taxpayer is not registered as a lender entitled to the deduction. RAS will provide the taxpayer an application for a Certificate of Registration -- Lender, information on proper registration procedures, and a Schedule L (if one was not received with the return). RAS will specify a reasonable amount of time in which the taxpayer must respond. If no response is received by the time specified, RAS will disallow the deduction. Lender returns which contain a bad debt deduction under Regulation 1642 but which do not result in a new credit return will be forwarded to Return Analysis Section. Lender credit returns will be forwarded to the Refund Section for analysis and processing.

**Local Revenue Allocation Section**

The Local Revenue Allocation Section (LRAS) will receive all scheduled type return batches for processing, including those with Schedule L, for the adjustment of local and district taxes based on bad debt deductions. A taxpayer who is not registered as a lender will be identified by an IRIS edit. On returns so identified, LRAS will not key the adjustments of local tax reported on Schedule L. Those returns will be forwarded to Return Analysis Section (RAS) for review and further processing. Lender credit returns will be forwarded to the Refund Section for analysis and processing. Lender returns which contain a bad debt deduction under Regulation 1642 but which do not result in a new credit return will be forwarded to Return Analysis Section.

**Refund Section – Claim for Refund Processing**

The Refund Section currently receives claims for refund filed under both WFS and AB 599. Generally, all election agreements submitted with claims for refund will be forwarded to the Taxpayer Records Unit for retention in the lender's central file.

When an election agreement is filed with a claim and the claim is subsequently referred to the district office for verification, the Refund Section will include either a copy of the election agreement or, depending on volume, a written notation in the referral confirming the appropriate election agreement has been filed. The written notation will identify the person entitled under the election to claim a bad debt deduction or refund for that particular account (i.e., retailer or lender or applicable assignee) and the effective dates.

It is anticipated most claims for refund will be filed in the form of credit returns which, as designed, will serve as the claims for refund. These claims will generally be routed from the Return Analysis Section or Local Revenue Allocation Section to the Refund Section for analysis and processing. Lender returns which contain a bad debt lender deduction under Regulation 1642 but which do not result in a net credit return will be processed as provided in this operations memo, section (III)(C)(l), Return Processing Procedures.

## IV. OBSOLESCENCE

This Operations Memo will become obsolete when the information contained herein is incorporated into the appropriate manuals.

Ramon J. Hirsig
Deputy Director
Sales and use Tax Department

Distribution: 1-D

## Exhibit One

**Listing of Documents and Information to Support Bad Debt Deductions in Connection with Repossessed Vehicles:**

**Total Population of Claim on Electronic Media (disc or CD-ROM)**

- Must exclude or readily identify loans that do not qualify
- Must identify loan origination date (Date contract entered into)
- Must include seller's/dealer's name and address (City and State)
- Must include consumer's name and address (City and State)
- Must include the following additional information:

    - Reference Number – Number assigned to each loan
    - Type of Vehicle/Property – e.g., vehicle, RV, mobile home, etc.
    - Date of Repossession Charge Off – The date charged off for income tax purposes
    - Loan Number – Actual loan account number
    - Charge Off or Loss Per Records – Amount charged off for income tax purposes
    - Summarized number of transactions in each local tax and district tax area

**Complete contract files must be available**

**Sample Selection**

- Minimum sample size of 300 loan contracts selected using statistical sampling procedures (i.e., random, systematic with random start, etc.). If the total population is equal to or less than 300, verification will be on an actual basis
- For each loan in the sample - Evidence that the uncollectible portion has been charged off for income tax purposes or in accordance with GAAP. Printouts from taxpayer accounting system will suffice
- For losses claimed under AB 599, an election agreement for each loan as required by subdivision (i)(3)(A) of Regulation 1642 and, if applicable, the election agreement required by either subdivision (h)(3)(A) or (i)(4)(A) of Regulation 1642

**Documentation and Information for Selected Sample**

- Complete contract file, including the "No Recourse" statement. If "No Recourse" statement is not available, copy of the contract/agreement between dealer and the financial institution establishing that the lender holds the account without recourse
- Reference Number – Number assigned to each loan
- Loan Origination Date – Date contract entered into
- Date of Repossession Charge Off – The date charged off for income tax purposes
- Loan Number – Actual loan account number
- Sales Price of Vehicle – Total amount subject to tax including document preparation charge and taxable smog
- Nontaxable Charges such as charges for optional service contracts, Smog Fee Impact, smog certificate fee, etc.
- Sales Tax – Tax reimbursement collected from the consumer on sale
- Vehicle License Fee
- Insurance – Net amount
- Down Payment
- Any Adjustments to the Principal
- Finance Charges – Net amount

- Payments on Principal
- Value of Repossession – Sales price for subsequent sale
- Charge Off or Loss Per Records – Amount charged off for income tax purposes
- Repossession Expense – Auctioneer's fees, reconditioning, etc.
- Recovery – Payments made after the loan is charged off on records
- Reversals – Adjustments for Non Sufficient Funds (NSF) checks, etc.
- Taxpayer must compute the amount of refund per Regulation 1642